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Indiana Law Journal

Volume 45 | Issue 3

Article 7

Spring 1970

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James J. Wilson

Indiana University School of Law

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Recommended Citation

Wilson, James J. (1970) "Use of Tax Benefit Principles to Override Section 337: D. B. Anders v. Commissioner," *Indiana Law Journal*: Vol. 45 : Iss. 3 , Article 7.

Available at: <http://www.repository.law.indiana.edu/ilj/vol45/iss3/7>

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USE OF TAX BENEFIT PRINCIPLES TO OVERRIDE SECTION 337: D. B. ANDERS V. COMMISSIONER

Normally, gain realized from the sale of assets pursuant to a liquidation under section 337 is not recognized to the corporation.¹ In *D. B. Anders v. Commissioner*,² however, the taxpayer was required to recognize gain received from the sale of previously expensed assets during the liquidation period, through the application of tax benefit principles,³ to override the express wording of section 337.

In *Anders*, an industrial laundry rental service sold previously expensed rental items consisting of laundered apparels, coveralls, towels, and other materials as part of its liquidation sale and claimed that section 337 precluded recognition of the gain on such items to the corporation. Agreeing with the taxpayer, the tax court⁴ held that the rental items were "property" within the definition of section 337(b)(1)⁵ and that section 337 explicitly requires that gain received on the sale of such items

1. INT. REV. CODE of 1954, § 337(a):

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

2. 48 T.C. 815, 24 Am. Fed. Tax R. 2d 69-5133 (10th Cir. 1969), *cert. denied*, — U.S. — (1969) (hereinafter *Anders*).

3. The recovery of an amount previously deducted from gross income which resulted in a tax benefit at the time of deduction, is taxable in the year of recovery. *Lake View Trust & Savings Bank*, 27 B.T.A. 290 (1932); *Helvering v. State Planters Bank & Trust Co.*, 130 F.2d 44 (4th Cir. 1942). For a discussion of tax benefit principles see Note, *The Tax Benefit, Recoveries, and Sales of Property Under Section 337*, 9 WILLIAM AND MARY L. REV. 476 (1968).

4. 48 T.C. 815 (1967).

5. INT. REV. CODE of 1954, § 337(b)(1):

(b) PROPERTY DEFINED.—

(1) IN GENERAL.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

shall not be recognized to the corporation.⁶ The Tenth Circuit Court of Appeals⁷ reversed, stating merely that there was no provision in the Code which bars the application of tax benefit principles to cases arising under section 337.⁸

APPLICATION OF ASSIGNMENT OF INCOME, PROPER
ACCOUNTING, AND TAX BENEFIT PRINCIPLES TO CASES
ARISING UNDER SECTION 337

In seeking the nonrecognition protection of section 337, the taxpayer in *Anders* asserted that its express language prohibited recognition of gain to the corporation on the sale of "property" within the liquidation period. However, the Commissioner has successfully employed several theories to reach gains resulting from the sale of such property pursuant to section 337. By requiring a change in the accounting method of a cash basis taxpayer, the Commissioner reached gain realized from the liquidation sale of contracts on which the income had been earned, but not collected.⁹ The Commissioner has also prevailed on "assignment of income" principles, as for example where a liquidating taxpayer sold assets consisting of earned, but uncollected income.¹⁰ Similarly, a transaction in which the taxpayer attempted to dispose of assets representing accrued interest on note obligations, was characterized by the Commissioner as a mere *collection* of accrued interest, and not a *sale or exchange* as required by section 337.¹¹ Thus recognition of the income to the corporation resulted.¹² In two other cases,¹³ a sale of receivables at

6. See note 1 *supra*.

7. 24 Am. Fed. Tax R. 2d 69-1533 (10th Cir. 1969).

8. Two other cases raising similar problems have succeeded *Anders* into the courts. In *Spitalny v. U.S.*, 288 F. Supp. 650 (1968), decided prior to the Tenth Circuit reversal of *Anders*, the court relied upon the tax court decision in *Anders* in holding that section 337 precluded the recognition of gain to the corporation resulting from the sale of previously expensed cattle feed and supplies during the liquidation period. In a case decided subsequent to the Tenth Circuit's reversal of *Anders*, however, the court in *Connery v. U.S.*, 24 Am. Fed. Tax R. 2d 69-5510 (1969), found the gain received from the sale of previously expensed prepaid advertising taxable to the corporation.

9. *Comm'r v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *Family Record Plan Inc. v. Comm'r*, 309 F.2d 208 (9th Cir. 1962) *cert. denied*, 378 U.S. 910 (1963). See INT. REV. CODE of 1954 § 446(b).

10. *Pridemark, Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965). The assignment of income principle is a common law theory which seeks to assure that income is taxed to the individual who earned it.

11. See note 1 *supra*.

12. *Central Building and Loan Assoc. v. Comm'r*, 34 T.C. 447 (1960). This holding has been criticized, however, since a *sale* was obviously effected, and the result could have been determined on proper accounting or assignment of income principles. See Lyon, *Ordinary Income May Arise in Section 337 Sales Under Assignment of Income Doctrine*, 16 J. TAX. 2 (1962); Gutkin and Beck, *Section 337: IRS Wrong in Taxing, At Time of Liquidation, Items Previously Deducted*, 17 J. TAX. 146 (1962).

13. *West Seattle Nat'l Bank of Seattle v. Comm'r*, 288 F.2d 47 (9th Cir. 1961);

face value, which had previously been deducted as bad debts, was designated a *recovery* and thus outside the nonrecognition protection afforded *gains*¹⁴ under section 337.¹⁵

With the exception of *Pridemark*, the courts in each of the cases cited above did not discuss the meaning of the word "property" in section 337 nor did they determine in each case, whether the item sold was actually section 337 "property."¹⁶ As a result of this omission it remains unclear whether the courts realized that common law tax principles were employed to override the express language of section 337.

It has been suggested¹⁷ that the definition of "property" in section 337 was taken from section 117 of the Internal Revenue Code of 1939,¹⁸ thereby restricting the meaning of "property" in section 337 so as to include only those assets which, if held for six months, would qualify for capital gains treatment.¹⁹ However, in view of the fact that section 337 prescribes the nonrecognition of gains or losses for a bulk sale of inventory, as well as for certain installment obligations, the provision can not be confined to capital assets.²⁰ Moreover, the Income Tax Regulations extend the definition of "property," with certain exceptions,²¹ to "all assets owned by a corporation,"²² and thus, restricting section 337 protection to capital assets alone would be improper.

In allowing the gain in *Anders* to go unrecognized, the tax court distinguished the cases cited above which avoided section 337 nonrecognition, as involving sales of *receivable income* rather than *assets*.²³ But the cases distinguished concerned sales of the right to receive income, which is an asset in the same way that an account receivable is an asset. Both the tax court in *Anders* and the courts which decided the receivable

Citizens Federal Savings and Loan Assoc. of Cleveland v. U.S., 290 F.2d 932 (Ct. Cl. 1061).

14. See note 1 *supra*.

15. But these two decisions were grounded on the codified tax benefit rule, INT. REV. CODE of 1954, § 111. The codified tax benefit rule deals specifically with the exclusion from gross income of recoveries of prior deductions which produced no tax benefit. However, section 111 has been interpreted in these two cases to provide by implication that recoveries of deducted amounts are taxable if a tax benefit was previously realized.

16. See Note, Section 337 "Property"—Trading In Stocks During Liquidation, 17 STANFORD L. REV. 970 (1964-5).

17. *Pridemark Inc. v. Comm'r*, 345 F.2d 35 (4th Cir. 1965); Note, *Tax-Free Sales In Liquidation Under Section 337*, 76 HARV. L. REV. 793 (1963).

18. INT. REV. CODE of 1939, ch. 1, § 117, 53 Stat. 50.

19. The successor of § 117 in the INT. REV. CODE of 1954 is § 1221.

20. B. BITTKER AND J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, § 9.65, (2d ed. 1966).

21. See Treas. Reg. § 1.337-3(a).

22. *Id.*

23. 48 T.C. at 823 (1967). See notes 9, 10, 12, 13 *supra*.

income cases failed to recognize that the former group of cases involved the sale of *assets* within the meaning of "property" in section 337. If the tax court meant to operate within the framework of prior case law in which assignment of income,²⁴ proper accounting,²⁵ and tax benefit principles²⁶ were used to avoid the express language of section 337, gain received upon the sale of the assets in *Anders* should have been recognized to the corporation through application of the tax benefit rule.

Another distinction mentioned by the tax court between the right-to-receive-income cases and *Anders*, was that in *Anders* the sale consisted of *operating* assets. Since the Income Tax Regulations²⁷ define "property" in section 337 to mean "assets," the operating asset distinction should be discarded as an unwarranted restriction on the coverage of section 337. The nature of the asset sold is not a valid basis of distinction in sales involving section 337. An asset is an asset, whether it consists of previously expensed laundry rental items or receivable income. Further, *Connery v. U.S.*²⁸ shows that the operating assets distinction has not proved to be viable. In *Connery*, the court relied upon the circuit court decision of *Anders* in holding that the gain received on the sale during liquidation of previously expensed prepaid advertising²⁹ should be taxable to the corporation. Previously expensed prepaid advertising is neither an operating asset, nor does it represent receivable income. It is rather a marketing expense which is deducted from earned income of the corporation. *Connery* is similar to *Anders* in that both cases concerned the sale of items which represented prior deductions from ordinary income, thus, equal treatment of the two situations would seem appropriate. But if nonrecognition under section 337 is allowed to turn on the operating asset distinction as suggested by the tax court in *Anders*, the results in these two similar cases would be inconsistent, since *Connery* did not involve the sale of operating assets.

It should also be noted that the sale in *Connery* parallels the right-to-receive-income cases. In both situations sales proceeds represented corporate income. In substance, the cases dealing with rights to receive income, and those involving the sale of previously expensed items are the same. It is immaterial that the former set of cases consisted of a sale of items which *should have been included* in corporate income, while the

24. See note 10 *supra*.

25. See note 9 *supra*.

26. See note 13 *supra*.

27. Treas. Reg. § 1.337-3(a).

28. 24 Am. Fed. Tax R. 2d 69-5510 (1969).

29. In *Connery*, the entire cost of the prepaid advertising was charged to an expense account upon purchase.

latter situations deal with the sale of items the cost of which was *deducted* from corporate income. The effect on the corporation's income is the same in both cases and the tax consequences should be consistent. The resulting similarity in effect on corporate income renders the formal distinctions made by the tax court in *Anders* difficult to sustain, and accordingly tax benefit principles should have been employed to find the proceeds from the sale of the expensed rental items taxable to the corporation.

Similarity between the receivable income cases and the expense situations suggests a functional identity between the proper accounting, assignment of income, and tax benefit principles. All three rules are instrumental in assuring that ordinary gain is taxed to the taxpayer earning the income. The tax court in *Anders* inaccurately distinguished the receivable income decisions which were grounded on assignment of income and proper accounting principles from the expense situation where the tax benefit rule is apposite. Aside from the interconnectedness of the three doctrines, however, the question remains whether, in any case, it is legitimate to employ them to override the express wording of section 337.

JUSTIFICATION FOR OVERRIDING SECTION 337

While the Code explicitly excludes certain types of assets from the definition of property protected by section 337, such as stock in trade or installment obligations,³⁰ it has been suggested that exceptions other than those specifically enumerated in section 337(b)(1) may exist.³¹ Since nonrecognition of gain in *Anders* would create a tax benefit to the taxpayer similar to that which would arise if the items excluded in section 337(b)(1) were not excluded, the result reached by the circuit court in *Anders* seems to be consistent with the purposes of that section, as well as with tax benefit principles. While this argument is an expedient way of reaching the *Anders* result under section 337, it does not provide a rule which would encompass similar situations under the closely related section 336,³² because the definition of property is not restricted in

30. See note 5 *supra*.

31. See note 16 *supra*. The use of the language "Property does not include" permits an inference that exceptions to the scope of the meaning of "property" are not limited to those specifically mentioned in § 337(b)(1). The word "includes" is defined in § 7701(b) as being not sufficient to exclude other things within the meaning of the term being defined through the use of "includes." By negative inference the phrase "does not include" may be interpreted to mean that other exceptions to the meaning of "property" in § 337 may exist.

32. INT. REV. CODE OF 1954, § 336:

Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

section 336 as it is in section 337.³³ Since assignment of income principles have been applied to section 336 cases,³⁴ another means must be found which justifies the use of assignment of income, proper accounting, and tax benefit principles to override the express language of sections 336 and 337.

In *Comm'r v. P.G. Lake, Inc.*,³⁵ the Supreme Court employed assignment of income principles to override the express wording of a provision in the Code. The taxpayer in *P.G. Lake* assigned its president an oil payment right in exchange for the cancellation of a debt. The taxpayer claimed the transaction was a sale of property (an interest in land) producing a profit taxable as long-term capital gain under section 117 of the Internal Revenue Code of 1939.³⁶ The Supreme Court, however, ruled that the assignment of income doctrine was not to be limited by the express language of section 117, and that gain on the transaction should be treated as ordinary income.

Both the assignment of income doctrine and tax benefit principles serve to assure that gain is taxable to the appropriate taxpayer at the time it is realized. By analogy to *P.G. Lake* section 337 should not be construed to prohibit the application of tax benefit principles to situations similar to that in *Anders*. It would be inconsistent, indeed, to hold that the assignment of income doctrine may not be restricted as in *P.G. Lake*, while holding, as did the tax court in *Anders*, that tax benefit principles could be so limited.

Furthermore, the decision in *P.G. Lake* has been read as an expression of general opposition to the "conversion"³⁷ of ordinary income into capital gain. Yet, the tax court in *Anders* apparently would sanction such a conversion.³⁸

In allowing the taxpayer a windfall gain, the tax court in *Anders* relied upon *Comm'r v. South Lake Farms, Inc.*³⁹ for the proposition that the literal meaning of section 337 must be followed even though it inadequately expressed the will of Congress.⁴⁰ In *South Lake*, it was held that the fair market value of an unharvested crop, planted and

33. See note 5 *supra*.

34. See *Williamson v. U.S.*, 292 F.2d 524 (Ct. Cl. 1961).

35. 356 U.S. 260 (1958).

36. Currently § 1221 of the Internal Revenue Code of 1954.

37. Lyon and Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, at 421 (1961-62).

38. If the taxpayer were awarded the benefit of the nonrecognition provisions of § 337, the usual double taxation of corporate income would be avoided. Hence, the conversion is effected by the reduced taxation on the gain received from the sale of the rental items.

39. 324 F.2d 837 (9th Cir. 1963).

40. 48 T.C. at 823 (1967).

cultivated by the liquidating corporation, but harvested by a new corporation which acquired all the stock⁴¹ of the liquidating concern, was not includable in the latter's final tax return, nor was the Commissioner allowed to recoup deductions taken by the old corporation for the expense of preparing the crop for harvest. The money, representing the recovered expenses in *South Lake*, by-passed the corporation and was part of the purchase price received by the stockholders for their stock. Clearly, *South Lake* parallels *Anders*. The stockholders in both instances received a sum which represented ordinary gain to the corporation. In both cases, it was the corporation which received the benefit of a prior deduction. The tax court's reliance on *South Lake* was proper. The circuit court opinion cannot be bolstered by distinguishing the case away. Accordingly it must be concluded that adoption of the circuit court's rationale would seriously undermine the continued validity of the Ninth Circuit's holding in *South Lake*.

COMPARISON TO DEPRECIATION SITUATION

A secondary argument of the taxpayer in *Anders* was that the gain on rental items resulted from a sale of the materials for an amount above their depreciated basis. The petitioner maintained that expensing the rental items in the year purchased was substantively similar to depreciating them on the basis of a one year useful life. The taxpayer then relied on *Fribourg Navigation Co., Inc. v. Comm'r*⁴² which held that gain from the sale of an asset above its depreciated basis is not subject to recapture.

In *Fribourg*, the taxpayer depreciated a Liberty ship for two years on the straightline method before selling it for an amount above the original purchase price. The value of the ship was enhanced due to the closing of the Suez Canal in 1958. The Supreme Court held that the sale of a depreciable asset above its adjusted basis at the beginning of the year of sale does not bar the depreciation deduction for that year.

Depreciation in *Fribourg* and expensing in *Anders* are parallel. But, the external factors in each case which intervened to disrupt the normal pattern differed. In *Fribourg* there was a change in market value while in *Anders* liquidation occurred.

In *Fribourg*, the Court emphasized that the Income Tax Regulations⁴³ did not permit a redetermination of deductions for depreciation

41. INT. REV. CODE of 1954, § 334. Section 334 concerns liquidations effected through the sale of all the corporation's capital stock.

42. 383 U.S. 272 (1966).

43. See Treas. Reg. §§ 1.167(a)-1(a) and 1.167(a)-1(c).

merely because of market fluctuations.⁴⁴ However, in *Anders* there did not exist any similar provision which would preclude the application of tax benefit principles to liquidations under section 337.

Perhaps in discussing *Fribourg* the appropriate question to ask is what result the Supreme Court would have reached had there not been a regulation which precluded the Commissioner's recovery. The court might well have reached the same conclusion as did the Tenth Circuit in *Anders*.

JAMES J. WILSON

44. 383 U.S. at 278 (1966).